TAX, RETIREMENT & ESTATE PLANNING SERVICES

TAX MANAGED STRATEGY 25

Corporate In-Kind Donating

As more and more corporations invest their retained earnings directly in various investment vehicles such as mutual funds and publicly traded securities, the value of their portfolio continues to grow. And as business owners build their corporation's portfolio, they may also want to give back while taking advantage of the tax benefits of donating investment funds to charity.[1] However, what many business owners may not know is that where corporate investments have increased in value, a corporate donation in-kind results in a more favourable tax consequence than selling the investment and donating the cash. Let's take a look at why this is the case and how the numbers stack up.

[1] The maximum amount of charitable donations that a corporation can claim as a deduction is equal to 75% of its net income for the year but this limit may be increased if the corporation donates certain capital property. The corporation cannot deduct charitable donations to create or increase a loss but unused charitable donations can be carried forward and used in any of the following five tax years.

SELL INVESTMENT & DONATE CASH VS. IN-KIND DONATION

SELL INVESTMENT & DONATE CASH

In order to obtain cash from an investment for the purpose of making a charitable donation it must be liquidated. And in cases where the fair market value (FMV) of the investment exceeds the adjusted cost base (ACB), this will result in a capital gain – 50 per cent of which is taxable (subject to any unused capital losses) and 50 per cent, the non-taxable portion, is added to corporation's capital dividend account (CDA). Following this, once the cash is donated to a registered charity, the corporation is allowed a deduction equal to the amount donated.

IN-KIND DONATION

The donation of an investment to a registered charity allows for a deduction in the corporation equal to the FMV of the investment donated and a capital gains inclusion rate that is reduced to zero per cent.[2] In other words, the tax on any capital gain arising from the disposition is eliminated – a significant savings. An additional benefit is that 100 per cent of the capital gain is added to the corporation's CDA.[3] This can result in an additional tax savings given that the amount in the CDA can be distributed as a capital dividend to the corporation's shareholder tax-free.

HERE'S HOW THE NUMBERS STACK UP

In order to illustrate the advantage of a corporation donating an investment in-kind versus selling the investment and donating the cash let's look at an example where a corporation holds an investment with a FMV of $10,000 and an ACB of zero.

As illustrated, by liquidating the investment and donating the cash to a registered charity, this results in a $2,300 corporate tax liability.[4] Alternatively, if the corporation donates the investment in-kind the capital gain will be eliminated resulting in no taxes owing. Furthermore, the full capital gain on the donated investment of $10,000 will be added to the corporation's CDA.

	IN-KIND DONATION ($)	SELL INVESTMENT & DONATE CASH ($)
Investment FMV	10,000	10,000
Investment ACB	-	-
Capital Gain	10,000	10,000
Taxable Capital Gain	-	5,000
Taxes Due on Capital Gain	-	2,300
Taxes comprised of the following:		
Provincial & Federal Tax (19.33%)	-	966
Refundable Federal Tax (26.67%)	-	1,334*
TOTAL TAX	**-**	**2,300**
Amount added to CDA	10,000	5,000

*The refundable tax is recovered after paying a taxable dividend to the corporation's shareholder.
For illustration purposes only.

[2] Subsection 38(a.1) of the *Income Tax Act* (Canada) ("ITA") provides that there is no tax on capital gains on publicly-traded securities donated to a charity.
[3] Subsection 89(1) of the ITA allows for the non-taxable portion of the capital gain to be added to the corporation's capital dividend account and can be distributed to shareholders tax-free.
[4] Assumes a 46% tax rate on investment income. Only 50% of realized capital gains are taxed at this rate (23%).

Now, if the corporation were to distribute $10,000 to its shareholder, you will see that in the case of an in-kind donation 100 per cent of the dividend could be paid in the form of a capital dividend and the shareholder would receive $10,000 tax-free. Alternatively, the shareholder would only receive $8,350 in after-tax dollars if the corporation sells the investment and gifts the cash. This is because only $5,000 could be paid in the form of a tax-free capital dividend and $5,000 of the distribution would need to be in the form of an ineligible dividend that would be taxed in the hands of the shareholder.[5] Taking into consideration both the corporate tax (net of the refundable tax portion) and personal taxes, a total of $2,616 of taxes will be paid where the investment is sold and the cash subsequently donated versus no tax in the case of an in-kind donation. Thus, the total net tax savings of making an in-kind donation versus selling the investment and donating the proceeds is $2,616 in taxes paid at both the corporate and personal level.

	IN-KIND DONATION ($)	SELL INVESTMENT & DONATE CASH ($)
Capital Dividend Paid to Shareholder	10,000	5,000
Ineligible Dividend Paid to Shareholder	-	5,000
Tax on Ineligible Dividend Paid	-	1,650**
Net Amount to Shareholder	**10,000**	**8,350**
Total Taxes	**-**	**2,616*****

** This is the tax that would be payable by the shareholder on an ineligible dividend. Assumes a 33% tax rate on ineligible dividends.
*** Corporate Tax of $966 + Personal Tax on Ineligible Dividend of $1,650 = $2,616. We assume that the corporation will get back the refundable Federal tax of $1,334 when it pays the ineligible dividend.
For illustration purposes only.

[5] Assumes the CDA balance was $zero prior to the donation-in-kind or sale and donation.

RESULTS

By donating an investment in-kind this can allow a corporation to:

1. Avoid triggering capital gains on the donated amount.
2. Increase its CDA by 100 per cent of the non-taxable portion of the capital gain which can be paid out tax-free.
3. Realize tax savings and make a tax-efficient distribution to its shareholder.

IDEAL CANDIDATES

Corporations who are:

- Looking to liquidate an investment that has a fair market value in excess of its adjusted cost base
- Planning to donate to charity and give back to their community
- Looking for more flexibility in terms of how and when they donate

TAKE ACTION

To take advantage of the tax savings associated with in-kind corporate donating:

- Review the corporation's portfolio to determine which investments have a fair market value that exceed their adjusted cost base
- Work with the registered charity of your choice to donate an investment in-kind

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